

DYNEGY INC.

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REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS

To the Board of Directors and Stockholders of Dynegy Inc.:

We have audited the accompanying consolidated balance sheets of Dynegy Inc. (a Delaware corporation formerly known as NGC Corporation) and subsidiaries as of December 31, 1998 and 1997, and the related consolidated statements of operations, changes in stockholders' equity and cash flows for each of the three years in the period ended December 31, 1998. These financial statements and the schedule referred to below are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Dynegy Inc. and subsidiaries as of December 31, 1998 and 1997, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 1998, in conformity with generally accepted accounting principles.

Our audits were made for the purpose of forming an opinion on the basic financial statements taken as a whole. The information included in Schedule I is presented for the purposes of complying with the Securities and Exchange Commission's rules and is not a required part of the basic financial statements. This schedule has been subjected to the auditing procedures applied in our audits of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

ARTHUR ANDERSEN LLP

Houston, Texas
February 24, 1999

DYNEGY INC.
CONSOLIDATED BALANCE SHEETS
(in thousands, except share data)

	<u>December 31, 1998</u>	<u>December 31, 1997</u>
ASSETS		
Current Assets		
Cash and cash equivalents	\$ 28,367	\$ 23,047
Accounts receivable, net	1,563,558	1,536,451
Accounts receivable, affiliates	60,180	139,321
Inventories	149,901	136,485
Assets from risk-management activities	219,105	127,929
Prepayments and other assets	96,130	55,547
	<u>2,117,241</u>	<u>2,018,780</u>
Property, Plant and Equipment	2,446,878	1,95X,250
Less: accumulated depreciation	<u>(514,771)</u>	<u>(436,674)</u>
	1,932,107	1,521,576
Other Assets		
Investments in unconsolidated affiliates	502,613	470,477
Assets from risk-management activities	135,100	111,341
Other assets	577,176	394,729
	<u>\$ 5,264,237</u>	<u>\$ 4,516,903</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities		
Accounts payable	\$ 1,370,902	\$ 1,404,736
Accounts payable, affiliates	113,827	24,1x7
Accrued liabilities and other	290,381	192.15')
Liabilities from risk-management activities	251.213	132,012
	<u>2,026,323</u>	<u>1,753,094</u>
Long-Term Debt	1,046,890	1,002,054
Other Liabilities		
Liabilities from risk-management activities	40,747	42.67'1
Deferred income taxes	317,537	254,059
Other long-term liabilities	504,677	245,892
	<u>3,936,174</u>	<u>3,297,778</u>
Company Obligated Preferred Securities of Subsidiary Trust	200,000	200,000
Commitments and Contingencies (Note 9)		
Stockholders' Equity		
Preferred stock, \$.01 par value, 50,000,000 shares authorized: 8,000,000 shares designated as Series A Participating Preferred Stock, 7,8 15.363 shares issued and outstanding at December 31, 1998 and 1997, respectively	75,418	75,418
Common stock, \$.01 par value, 400,000,000 shares authorized: 153,298,220 shares issued at December 31, 1998 and 151,796,622 shares issued at December 31, 1997	1,533	1,518
Additional paid-in capital	935,183	919,720
Retained earnings	133,340	32,975
Less: treasury stock, at cost: 1,200,700 shares at December 31, 199X and 654,900 shares at December 3 I, 1997	<u>(17,411)</u>	<u>(10,506)</u>
	<u>1,128,063</u>	<u>1,019,125</u>
	<u>\$ 5,264,237</u>	<u>\$ 4,516,903</u>

See Notes to Consolidated Financial Statements

DYNEGY INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share data)

	Year Ended December 31.		
	1998	1997	1996
Revenues	\$ 14,257,997	\$ 13,378,380	\$ 7,260,202
Cost of sales	<u>13,829,310</u>	<u>12,993,086</u>	<u>6,890,702</u>
Operating margin	428,687	385,294	369,500
Depreciation and amortization	113,202	104,391	71,676
Impairment, abandonment and other charges	9,644	275,000	
General and administrative expenses	<u>185,708</u>	<u>149,344</u>	<u>100,032</u>
Operating income (loss)	120,133	(143,441)	197,792
Equity in earnings of unconsolidated affiliates	91,038	58,959	28,075
Other income	46,821	28,113	5,485
Relocation costs			(4,000)
Interest expense	(74,992)	(63,455)	(46,202)
Other expenses	(7,677)	(20,230)	(11,505)
Minority interest in income of a subsidiary	<u>(16,632)</u>	<u>(9,841)</u>	
Income (loss) before income taxes	158,691	(149,895)	169,645
Income tax provision (benefit)	<u>50,338</u>	<u>(62,210)</u>	<u>56,323</u>
Net income (loss) from continuing operations before cumulative effect of accounting change	108,353	(87,685)	113,322
Cumulative effect of change in accounting principle (net of income tax benefit of \$7,913)	<u>---</u>	<u>(14,800)</u>	
NET INCOME (LOSS)	<u>\$ 108,353</u>	<u>\$ (102,485)</u>	<u>\$ 113,322</u>
Net Income Per Share:			
Net income (loss) from continuing operations	\$ 108,353	\$ (87,685)	\$ 113,322
Cumulative effect of change in accounting principle (net of income tax benefit of \$7,913)	<u>---</u>	<u>(14,800)</u>	<u>---</u>
Less: preferred stock dividends	<u>(391)</u>	<u>(391)</u>	<u>(132)</u>
Net income (loss) applicable to common stockholders	<u>\$ 107,962</u>	<u>\$ (102,876)</u>	<u>\$ 113,190</u>
Basic earnings (loss) per share	\$ 0.71	\$ (0.68)	\$ 0.99
Diluted earnings per share	\$ 0.66	\$ n/a	\$ 0.83
Basic shares outstanding	<u>151,619</u>	<u>150,653</u>	<u>114,093</u>
Diluted shares outstanding	<u>164,605</u>	<u>167,009</u>	<u>136,099</u>

See Notes to Consolidated Financial Statements

DYNEGY INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

	Year Ended December 31,		
	1998	1997	1996
CASH FLOWS FROM OPERATING ACTIVITIES			
Net income (loss)	\$ 108,353	\$ (102,485)	4 113,322
Items not affecting cash flows from operating activities:			
Depreciation, amortization, impairment and abandonment	102,577	378,916	73,176
Equity in earnings of affiliates, net of cash distributions	(6,477)	(4,073)	(21,729)
Risk management activities	(7,422)	(8,757)	(11,220)
Deferred income taxes	52,308	(86,424)	45,896
Amortization of bond premium	(2,572)	(6,758)	(4,892)
Other, including gains on sale of assets	(22,540)	1,249	7,466
Change in assets and liabilities resulting from operating activities:			
Accounts receivable	5,104	(35,845)	(954,418)
Inventories	(17,380)	86,077	(116,353)
Prepayments and other assets	(30,605)	(20,686)	7,726
Accounts payable	44,113	(22,601)	778,767
Accrued liabilities	(27,699)	14,064	47,148
Other, "et	7,078	85,922	4,157
Net cash provided by (used in) operating activities	<u>250,780</u>	<u>278,589</u>	<u>(30,954)</u>
CASH FLOWS FROM INVESTING ACTIVITIES			
Capital expenditures	(298,738)	(220,003)	(97,651)
Investment in unconsolidated affiliates	(78,096)	(27,708)	(30,875)
Business acquisitions, net of cash acquired	(2,644)	(715,589)	(714)
Proceeds from asset sales	45,044	452,565	3,600
Other, "et	<u>39,352</u>	<u>---</u>	<u>14,500</u>
Net cash used in investing activities	<u>(295,082)</u>	<u>(510,735)</u>	<u>(111,140)</u>
CASH FLOWS FROM FINANCING ACTIVITIES			
Proceeds from long-term borrowings	212,259	2,218,500	1,542,000
Repayments of long-term borrowings	(493,277)	(2,198,275)	(1,360,081)
Net proceeds from commercial paper and money market lines of credit	350,758	---	---
Proceeds from sale of capital stock, options and warrants	3,863	5,147	858
Issuance of company obligated preferred securities of a subsidiary trust, net	---	198,043	---
Treasury stock acquisitions	(6,905)	(10,506)	---
Dividends and other distributions, net	(7,988)	(7,925)	(6,740)
Other, "et	<u>(9,088)</u>	<u>---</u>	<u>---</u>
Net cash provided by financing activities	<u>49,622</u>	<u>204,984</u>	<u>176,037</u>
Net increase (decrease) in cash and cash equivalents	5,320	(27,162)	33,943
Cash and cash equivalents, beginning of year	<u>23,047</u>	<u>50,209</u>	<u>16,266</u>
Cash and cash equivalents, end of year	<u>\$ 28,367</u>	<u>\$ 23,047</u>	<u>\$ 50,209</u>

See Notes to Consolidated Financial Statements.

DYNEGY INC.
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
(in thousands)

	Series A Preferred		Common Stock		Additional	Retained	Treasury Stock	
	Shares	Amount	Shares	Amount	Paid-In Capital	Earnings	Shares	Amount
Balance at December 31, 1995	-	\$ -	110,493	\$ 1,105	\$ 515,785	\$ 35,490		\$ -
Chevron Combination	7,815	75,418	38,623	386	372,328			
Net income						113,322		
Options exercised			374	3	1,320			
Dividends and other								
Distributions	-					(5,427)		
401(k) plan and profit sharing stock issuances	-		309	4	3,175			
Options granted	-				2,824			
Other			48					
Balance at December 31, 1996	7,815	75,418	149,847	1,498	896,432	143,385		
Net loss						(102,485)		
Options exercised			1,541	15	11,577			
Dividends and other								
Distributions	-					(7,925)		
401(k) plan and profit sharing stock issuances			385	5	7,401			
Options granted	-				4,044			
Treasury stock acquisitions		-					(655)	(10,506)
Other		-	24		266			
Balance at December 31, 1997	7,815	75,418	151,797	1,518	919,720	32,975	(655)	(10,506)
Net income						108,353		
Options exercised			1,032	10	3,808			
Dividends and other								
Distributions	-					(7,988)		
401(k) plan and profit sharing stock issuances			457	5	6,822			
Options granted	-				4,675			
Treasury stock acquisitions	-						(546)	(6,905)
Other	-		12		158			
Balance at December 31, 1998	<u>7,815</u>	<u>\$75,418</u>	<u>153,298</u>	<u>\$ 1,533</u>	<u>\$ 935,183</u>	<u>\$ 133,340</u>	<u>(1,201)</u>	<u>\$ (17,411)</u>

See Notes to Consolidated Financial Statements

DYNEGY INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1 -- ACCOUNTING POLICIES

Dynegy Inc. ("Dynegy" or the "Company") is a holding company that conducts substantially all of its business through its subsidiaries. The Company is a leading provider of energy products and services in North America and the United Kingdom. Products marketed by the Company's wholesale marketing operations include natural gas, electricity, coal, natural gas liquids, crude oil, liquid petroleum gas and related services. The Company's wholesale marketing operations are supported by ownership or control of an extensive asset base and transportation network that includes unregulated power generation, gas and liquids storage capacity, gas, power and liquids transportation capacity and gas gathering, processing and fractionation assets.

The accounting policies of Dynegy reflect industry practices and conform to generally accepted accounting principles. The more significant of such accounting policies are described below. The preparation of the consolidated financial statements in conformity with generally accepted accounting principles requires management to develop estimates and make assumptions that affect reported financial position and results of operations and that impact the nature and extent of disclosure, if any, of contingent assets and liabilities. Actual results could differ from those estimates.

Principles Of Consolidation. The accompanying consolidated financial statements include the accounts of the Company and its majority-owned subsidiaries after elimination of intercompany accounts and transactions. Investments in affiliates in which the Company has a significant ownership interest, generally 20 percent to 50 percent, are accounted for by the equity method. Other investments are carried at cost. Certain reclassifications have been made to prior-period amounts to conform with current period financial statement classifications.

Cash and Cash Equivalents. Cash and cash equivalents consist of all demand deposits and funds invested in short-term investments with original maturities of three months or less.

Concentration Of Credit Risk. Dynegy provides multiple energy commodity solutions principally to customers in the electric and gas distribution industries and to entities engaged in industrial and petrochemical businesses. These industry concentrations have the potential to impact the Company's overall exposure to credit risk, either positively or negatively, in that the customer base may be similarly affected by changes in economic, industry or other conditions. Receivables are generally not collateralized; however, Dynegy believes the credit risk posed by industry concentration is offset by the diversification and creditworthiness of the Company's customer base.

Inventories. Inventories consisting primarily of natural gas in storage of \$78.2 million and \$35.2 million, natural gas liquids of \$23.4 million and \$55.4 million, and crude oil of \$25.2 million and \$23.2 million at December 31, 1998 and 1997, respectively, are valued at the lower of weighted average cost or at market. Materials and supplies inventory of \$23.1 million and \$19.8 million at December 31, 1998 and 1997, respectively, is carried at the lower of cost or market using the specific identification method.

Property, Plant and Equipment. Property, plant and equipment consisting principally of gas gathering, processing, fractionation, terminaling and storage facilities, natural gas transmission lines, pipelines, power generating facilities and supporting infrastructure is recorded at cost. Expenditures for major replacements and renewals are capitalized while expenditures for maintenance, repairs and minor renewals to maintain facilities in operating condition are expensed. Depreciation is provided using the straight-line method over the estimated economic service lives of the assets, ranging from three to 30 years. Composite depreciation rates are applied to functional groups of property having similar economic characteristics. Gains and losses are not recognized for retirements of property, plant and equipment subject to composite depreciation rates ("composite rate") until the asset group subject to the composite rate is retired. The Company reviews the carrying value of its long-lived assets in accordance with provisions of Financial Accounting Standard No. 121, "Accounting for the Impairment of Long-Lived Assets."

Environmental Costs. Environmental costs relating to current operations are expensed or capitalized, as appropriate, depending on whether such costs provide future economic benefit. Liabilities are recorded when environmental assessment indicates that remedial efforts are probable and the costs can be reasonably estimated. Measurement of liabilities is based on currently enacted laws and regulations, existing technology and undiscounted, site-specific costs. Environmental liabilities in connection with assets that are sold or closed are realized upon such sale.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

or closure, to the extent they are probable, can be estimated and have not previously been reserved. In assessing environmental liabilities, no offset is made for potential insurance recoveries. Recognition of any joint and several liability is based upon the Company's best estimate of its final pro rata share of such liability.

Intangible Assets. Intangible assets are generally amortized by the straight-line method over an estimated useful life of up to 30 years.

Revenue Recognition. Revenues for product sales and gas processing and marketing services are recognized when title passes to the customer or when the service is performed. Fractionation and transportation revenues are recognized based on volumes received in accordance with contractual terms. Revenues derived from power generation are recognized upon output, product delivery or satisfaction of specific targets, all as specified by contractual terms. Fees derived from engineering and construction contracts and development and other activities received from joint ventures in which Dynegy holds an equity interest are deferred to the extent of Dynegy's ownership interest and amortized on a straight-line basis over appropriate periods, which vary according to the nature of the service provided and the ventures' operations.

The Company accounts for its North American fixed-price natural gas transactions using the mark-to-market method of accounting. Under such method, all fixed-price natural gas contracts are recorded at fair value, net of future servicing costs and reserves. Changes in the market value of these contracts are recognized as gain or loss in the period of change. The resulting unrealized gains and losses are recorded as assets and liabilities from risk management activities. The accrual method of accounting is used for fixed-price natural gas transactions in the United Kingdom and for accounting for fixed-price commodity transactions in its wholesale power, NGL and crude marketing activities.

The Company routinely enters into financial instrument contracts to hedge purchase and sale commitments, fuel requirements and inventories in its natural gas liquids, crude oil, electricity and coal businesses in order to minimize the risk of market fluctuations. Dynegy also monitors its exposure to fluctuations in interest rates and foreign currency exchange rates and may execute swaps, forward-exchange contracts or other financial instruments to manage these exposures. Gains and losses from hedging transactions are recognized in income and are reflected as cash flows from operating activities in the periods for which the underlying commodity, interest rate or foreign currency transaction was hedged. If the necessary correlation to the commodity, interest rate or foreign currency transaction being hedged ceases to exist, the gain or loss associated with such contract(s) is no longer deferred and is recognized in the period correlation is lost.

Income Taxes. The Company files a consolidated United States federal income tax return and, for financial reporting purposes, provides income taxes for the difference in the tax and financial reporting bases of its assets and liabilities in accordance with Statement of Financial Accounting Standards ("SFAS") No. 109, "Accounting for Income Taxes."

Earnings Per Share. Basic earnings per share represents the amount of earnings for the period available to each share of common stock outstanding during the period. Diluted earnings per share represents the amount of earnings for the period available to each share of common stock outstanding during the period plus each share that would have been outstanding assuming the issuance of common shares for all dilutive potential common shares outstanding during the period. Differences between basic and diluted shares outstanding in all periods are attributed to the Series A Convertible Participating Preferred Stock, options outstanding and a warrant.

Foreign Currency Translations. For subsidiaries whose functional currency is other than U.S. dollar, assets and liabilities are translated at year-end rates of exchange and revenues and expenses are translated at average exchange rates prevailing during the year. For each of the three years in the period ended December 31, 1998, items of other comprehensive income were immaterial to the Company's operating results.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 2 -- RISK MANAGEMENT AND FINANCIAL INSTRUMENTS

Dynegy's operating results are impacted by commodity price, interest rate and foreign exchange rate fluctuations. The Company routinely enters into financial instrument contracts to hedge purchase and sale commitments, fuel requirements and inventories in its natural gas, natural gas liquids, crude oil, electricity and coal businesses in order to minimize the risk of market fluctuations. However, as a result of marketplace liquidity and other factors, the Company may, at times, be unable to hedge certain identified market risks. Further, the Company may, at times, have a bias in the market, within established guidelines, resulting from the management of its commodity portfolios. Dynegy also monitors its exposure to fluctuations in interest rates and foreign currency exchange rates and may execute swaps, forward-exchange contracts or other financial instruments to manage these exposures.

Operating margins in the Wholesale Gas and Power segment are separated into three integrated component businesses: wholesale gas marketing, wholesale power marketing and power generation. Operating margins earned by wholesale gas and power marketing, exclusive of risk-management activities, are relatively insensitive to commodity price fluctuations since most of the purchase and sales contracts do not contain fixed-price provisions. Generally, prices contained in these contracts are tied to a current spot or index price and, therefore, adjust directionally with changes in overall market conditions. However, market price fluctuations for natural gas and electricity can have a significant impact on the operating margin ~~derived~~ from risk-management activities in these businesses. Further, differences in the comprehensive methods of accounting for North American fixed-price natural gas transactions, which are accounted for under the mark-to-market method, and natural gas marketing transactions in the U.K. and power marketing transactions, which are both accounted for under accrual accounting, create differences in the timing of the recognition of such commodity price movements. Fuel costs, principally natural gas, represent the primary variable cost impacting margins at the Company's power generating facilities. Historically, operating margins have been relatively insensitive to commodity price fluctuations since most of this business's purchase and sales contracts contain variable power sales contract features tied to a current spot or index natural gas price, allowing revenues to adjust directionally with changes in natural gas prices. However, the financial performance and cash flow derived from the Company's investment in merchant generation capacity is sensitive to changes in, and the relationship between, natural gas and electricity prices.

Operating margins associated with the Liquids segment's natural gas gathering, processing and fractionation activities are very sensitive to changes in natural gas liquids prices, principally as a result of contractual terms under which natural gas is processed and products are sold by these businesses and the availability of inlet volumes. In addition, certain of the Liquids Businesses' processing plant assets are impacted by changes in, and the relationship between, natural gas and natural gas liquids prices which, in turn influences the volumes of gas processed. Commodity price fluctuations also impact the operating margins derived from the Liquids segment's natural gas liquids and crude oil marketing businesses.

Dynegy's commercial groups manage, on a portfolio basis, the market risks inherent in their transactions, subject to parameters established by the Dynegy Board of Directors. Market risks are monitored by a risk control group that operates independently from the commercial units that create or actively manage these risk exposures to ensure compliance with Dynegy's risk management policies. Risk measurement is also practiced against the Dynegy portfolios with stress testing and scenario analysis.

Accounting for Price Risk Management Activities -- Natural Gas. The Company uses the mark-to-market method of accounting for its North American fixed-price natural gas transactions. Under mark-to-market accounting, fixed-price forwards, swaps, options, futures and other financial instruments with third parties are reflected at market value, net of future servicing costs and reserves, with resulting unrealized gains and losses recorded as assets and liabilities from risk management activities in the consolidated balance sheets. These assets and liabilities are affected by the actual timing of settlements related to these contracts and current-period changes resulting primarily from newly originated transactions and the impact of price movements. These changes are recognized as revenues in the consolidated statements of operations in the period in which the change occurs. Market prices used to value outstanding financial instruments reflect management's consideration of, among other things, closing exchange and over-the-counter quotations, the time value of money and volatility factors underlying the commitments. These market prices are adjusted to reflect the potential impact of liquidating Dynegy's position in an orderly manner over a reasonable period of time under present market conditions.

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Market Risk. Dynegy generally attempts to balance its fixed-price physical and financial purchase and sales contracts in terms of contract volumes and the timing of performance and delivery obligations. However, net open positions often exist or are established due to the origination of new transactions and the Company's assessment of, and response to, changing market conditions. Dynegy will take advantage of its bias in the market when it believes, based upon competitive information gained from its energy marketing activities, that future price movements will be consistent with its net open position. To the extent a net open position exists, Dynegy is exposed to the risk that fluctuating market prices may adversely impact its financial position or results of operations. The net open position is actively managed, and the impact of a change in price on the Company's financial condition at a point in time is not necessarily indicative of the impact of price movements throughout the year.

Market Reserves. In connection with the market valuation of its fixed-price contracts, the Company maintains certain reserves for a number of risks and costs associated with these future commitments. Among others, these include reserves for credit risks based on the financial condition of counterparties, reserves for product location ("basis") differentials and consideration of the time value of money for long-term contracts. Counterparties in its trading portfolio consist principally of financial institutions, major energy companies and local distribution companies. The creditworthiness of these counterparties may impact overall exposure to credit risk, either positively or negatively; however, with regard to its counterparties Dynegy maintains credit policies that management believes minimize overall credit risk. Determination of the credit quality of its counterparties is based upon a number of factors, including credit ratings, financial condition, project economics and collateral requirements. When applicable, the Company employs standardized agreements that allow for the netting of positive and negative exposures associated with a single counterparty. Based on these policies, its current exposures and its credit reserves, Dynegy does not anticipate a material adverse effect on its financial position or results of operations as a result of counterparty nonperformance. The following table displays the mark-to-market portfolio value of Dynegy's natural gas fixed-price transactions at December 31, 1998:

	Investment Grade Credit Quality	Below Investment Grade Credit Quality	Total
	(\$ in thousands)		
Utilities and power generators	\$ 41,752	\$ 13,213	\$ 60,965
Financial institutions	(22,217)		(22,217)
Oil and gas producers	14,697	12,605	27,302
Industrial companies	352	5,103	5,455
Other	3,347	204	3,551
Value of fixed-price transactions before reserves	<u>\$ 43,931</u>	<u>\$ 31,125</u>	75,056
Reserves			(6,346)
Net fixed-price value			<u>\$ 68,710</u>

At December 31, 1998, the term of Dynegy's natural gas portfolio extends to 2007, and the average remaining life of an individual transaction was 3 months.

Comprehensive Change in Accounting Principles. As a result of recent pronouncements issued by the Financial Accounting Standards Board and the Emerging Issues Task Force, the Company's comprehensive method of accounting for energy-related contracts and/or derivative instruments and hedging transactions is changing. Previously, only North American fixed-price natural gas transactions were recorded at fair value, net of future servicing costs and reserves as estimated by the Company. The Company does not anticipate that its current mark-to-market accounting for fixed-price natural gas contracts will be significantly affected by the adoption of Financial Accounting Standard No. 133, "Accounting for Derivative Instruments and Hedging Activities" ("Statement No. 133") or by the Emerging Issues Task Force's conclusions in EITF 98-10, "Accounting for Energy Trading and Risk Management Activities" ("EITF 98-10"). However, provisions in Statement No. 133 and in EITF 98-10 will affect the accounting for other trading and marketing operations that are currently accounted for under the accrual method. Further, provisions in Statement No. 133 will affect the accounting for and disclosure of other contractual arrangements and operations of the Company. The Company is required to adopt the provisions of EITF 98-10 effective January 1, 1999. The cumulative effect of the change in accounting resulting from adoption of the provisions of EITF 98-10 is immaterial. The transition rules under

DYNEGY INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Statement No. 133 provide for early adoption as of the beginning of any fiscal quarter subsequent to June 15, 1998, Dynegy intends to adopt the provisions of Statement No. 133 within the timeframe and in accordance with the requirements provided by that statement.

Fair Value of Financial Instruments. The following disclosure of the estimated fair value of financial instruments is made in accordance with the requirements of SFAS No. 107, "Disclosures About Fair Value of Financial Instruments." The estimated fair-value amounts have been determined by the Company using available market information and selected valuation methodologies. Considerable judgment is required in interpreting market data to develop the estimates of fair value. The use of different market assumptions or valuation methodologies could have a material effect on the estimated fair-value amounts.

The carrying values of current assets and liabilities approximate fair values due to the short-term maturities of these instruments. The carrying amounts and fair values of the Company's other financial instruments were:

	December 31,			
	1998		1997	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
	(\$ in thousands)			
Commercial Paper	\$ 518,643	\$ 518,643	\$ 229,500	\$ 229,500
Money market lines of credit	20,000	20,000	---	---
Credit Agreement	---	---	110,000	110,000
Canadian Credit Agreement	40,000	40,000	---	---
6.75% Senior Notes, due 2005	150,000	152,000	150,000	152,000
7.625% Senior Notes, due 2026	175,000	179,000	175,000	188,000
7.125% Senior Notes, due 2018	175,000	172,000	---	---
Power Generation Notes	103,126	103,126	---	---
Chevron Note	---	---	156,982	159,000
14% Senior Subordinated Notes, due 2001	---	---	70,063	71,000
10.25% Subordinated Notes, due 2003	---	---	110,234	111,000
Preferred Securities of a Subsidiary Trust	200,000	204,000	200,000	223,000
Interest rate risk-management contracts	---	8,474	---	3,470
Foreign currency risk-management contracts	4,418	5,491	892	(375)
Commodity risk-management contracts	(29,222)	(30,977)	(23,167)	(25,047)

The financial statement carrying amounts of the Company's credit agreement and variable-rate debt were assumed to approximate fair value. The fair values of the Company's other long-term indebtedness, including the Preferred Securities of a Subsidiary Trust but excluding the Chevron Note, were based on quoted market prices by financial institutions that actively trade these debt securities. The fair value of the Chevron Note was determined by comparison to publicly traded instruments having similar terms and conditions. The fair value of the Company's cost basis investments was not estimated as the investments were considered immaterial. The fair value of interest rate, foreign currency and commodity risk-management contracts were based upon the estimated consideration that would be received to terminate those contracts in a gain position and the estimated cost that would be incurred to terminate those contracts in a loss position. The interest rate swap contracts, foreign currency forward exchange contracts and commodity swap and option agreements extend for periods of up to 12, 2 and 9 years, respectively. The absolute notional contract amounts associated with the commodity risk-management, interest rate and forward exchange contracts, respectively, were as follows:

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

	December 31,		
	1998	1997	1996
Natural Gas (Trillion Cubic Feet)	4.179	2.558	1.535
Electricity (Million Megawatt Hours)	1.835	2.244	...
Natural Gas Liquids (Million Barrels)	6.397	4.355	3.270
Crude Oil (Million Barrels)	18.800	14.920	2.034
Interest Rate Swaps (in thousands of US Dollars)	\$ 69,332	\$ 180,000	\$
Fixed Interest Rate Paid on Swaps	\$ 8,067	6,603	...
U.K. Pound Sterling (in thousands of US Dollars)	\$ 69,254	\$ 74,638	\$
Average U.K. Pound Sterling Contract Rate (in US Dollars)	1.6143	\$ 1.5948	\$
Canadian Dollar (in thousands of US Dollars)	\$ 268,307	\$ 37,041	\$
Average Canadian Dollar Contract Rate (in US Dollars)	\$ 0.6710	\$ 0.7240	\$

Cash-flow requirements for these commodity risk-management, interest rate and foreign exchange contracts were estimated based upon market prices in effect at December 31, 1998. Cash-flow requirements were as follows:

	1999	2000	2001	2002	2003	Beyond
	(\$ in thousands)					
Future estimated net inflows (outflows) based on year end market prices/rates	\$ 38,104	\$ (9,574)	\$ (3,475)	\$ (2,473)	\$ 180	\$ 1,073

Note 3 -- CASH FLOW INFORMATION

Detail of supplemental disclosures of cash flow and non-cash investing and financing information was:

	Year Ended December 31,		
	1998	1997	1996
	(\$ in thousands)		
Interest paid (net of amount capitalized)	\$ 83,376	\$ 60,323	\$ 22,647
Taxes paid (net of refunds)	\$ (8,000)	\$ 8,043	\$ 1,467
Detail of businesses acquired:			
Current assets and other	\$ 5,144	\$ 547,505	\$ 76,490
Fair value of non-current assets	101,630	503,789	967,575
Liabilities assumed, including deferred taxes	(104,130)	(268,092)	(595,219)
Capital stock issued and options exercised	---	---	(448,132)
Cash balance acquired	---	(67,613)	---
Cash paid, net of cash acquired	\$ 2,644	\$ 715,589	\$ 714

DYNEGY INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 4 -- PROPERTY, PLANT AND EQUIPMENT

Investments in property, plant and equipment consisted of:

	December 31,	
	1998	1997
	(\$ in thousands)	
Wholesale Gas and Power Segment:		
Natural gas and power marketing	\$ 1,514	\$ 2,588
Power generation	351,378	48,866
Liquids Segment:		
Natural gas processing	1,241,658	1,211,727
Fractionation	185,198	152,501
Liquids marketing	139,328	178,820
Natural gas gathering and transmission	429,631	275,116
Crude oil	43,118	44,977
Other	55,053	43,655
	2,446,878	1,958,250
Less: accumulated depreciation	(514,771)	(436,674)
	<u>\$ 1,932,107</u>	<u>\$ 1,521,576</u>

Interest capitalized related to costs of projects in process of development totaled \$7.6 million. \$8.8 million and \$1.2 million for each of the three years in the period ended December 31, 1998.

During the second quarter of 1998, the Company purchased all of the outstanding partnership interests held by third parties in three limited partnerships, each formed for the purpose of owning and operating a discrete power generation facility in the State of California. As a result, the Company now consolidates the aggregate assets, liabilities and results of operations associated with these projects.

Note 5 -- UNCONSOLIDATED AFFILIATES

The equity method of accounting is used for investments in certain partnerships and for investments in companies in which Dynegy has a voting interest between 20 percent and 50 percent. Such investments include:

Accord Energy Limited. Accord was formed in IYYJ to market energy resources in the United Kingdom and Europe. Prior to 1997, Dynegy owned a 49 percent limited partner interest in Accord. In January 1997, such interest was converted to a 25 percent participating preferred stock interest.

NICOR Energy, L.L.C. ("NICOR"). NICOR is a retail energy alliance formed with NICOR Energy Management Services, a subsidiary of NICOR Inc., to provide energy services to industrial, commercial and residential customers in the Midwest. Dynegy owns a 50 percent interest in this Delaware limited liability company.

SouthStar Energy Services L.L.C. SouthStar is a retail energy alliance formed with AGL Resources Inc. and Piedmont Natural Gas Company. The company offers a combination of unregulated energy products and services to industrial, commercial and residential customers in the southeast. Dynegy owns a 20 percent interest in this Delaware limited liability company.

Power Generation Partnerships. Dynegy owns interests in fifteen joint ventures, each formed to build, own and operate cogeneration facilities. The Company's interests in these joint ventures range from eight to 50 percent. Each partnership interest is accounted for under the equity method. Construction of the cogeneration facilities owned by each of the joint ventures was project financed and the obligations of the joint ventures are non-recourse to the Company. At December 31, 1998, the unamortized excess of the Company's investment in these joint ventures over its equity in the underlying net assets of the affiliates approximated \$160 million. This amount is being amortized on the straight-line method over the estimated economic service lives of the underlying assets.

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. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Quicktrade L.L.C. ("Quicktrade"). Quicktrade, a Delaware limited liability company, was formed to develop, implement and operate an electronic trading system. Dynegy owned a 65.5 percent interest in this LLC during 1998 and the LLC was consolidated in the accompanying financial Statements during 1998. During 1996 and 1997, the Company owned varying interests in Quicktrade and accounted for its interest under the equity method for the majority of those years. Effective January 1, 1999, the Company sold its interest in Quicktrade.

Gulf Coast **Fractionators ("GCF").** GCF is a Texas limited partnership that owns and operates a natural gas liquids fractionation facility located in Mont Belvieu, Texas. Dynegy owns a 38.75 percent limited partner interest in GCF. At December 31, 1998, the unamortized excess of the Company's investment in GCF over its equity in the underlying net assets of the affiliate approximated \$16 million. This amount is being amortized on the straight-line method over the estimated economic service life of the GCF assets.

West Texas LPG Pipeline Partnership ("West Texas Partnership"). The West Texas Partnership, a Texas limited partnership, holds all of the assets comprising the West Texas Pipeline, an interstate natural gas liquids pipeline. Dynegy owns a 49 percent interest in the West Texas Partnership acquired as part of the Chevron Combination. At December 31, 1998, the unamortized excess of the Company's investment in the West Texas Partnership over its equity in the underlying net assets of the affiliate approximated \$43 million. This amount is being amortized on the straight-line method over the estimated economic service life of the underlying assets.

Venice Energy Services Company, L.L.C. ("VESCO"). VESCO is a Delaware limited liability company that owns and operates a natural gas processing, extraction, fractionation and storage facility located in Plaquemines Parish, Louisiana. Dynegy is operator of the facility and originally acquired a 37 percent interest in Venice Gas Processing Company ("Venice") effective November 1, 1996. In 1997, Venice reorganized as a limited liability company and, in September 1997, the VESCO members agreed to expand ownership in VESCO to include an affiliate of Shell Midstream Enterprises, a subsidiary of Shell Oil Company ("Shell"), effective September 1, 1997, in exchange for Shell's commitment of certain offshore reserves to VESCO. The transaction reduced Dynegy's interest in VESCO from 37 percent to approximately 32 percent, as of the effective date. Koch Energy Services Company ("Koch") acquired an interest in VESCO during 1998 pursuant to its contribution of a cryogenic gas-processing unit to VESCO. The transaction reduced Dynegy's interest in VESCO to approximately 23 percent. Dynegy operates the facility and has commercial responsibility for product distribution and sales.

Waskom Gas Processing Company ("Waskom"). Waskom is a Texas general partnership that owns and operates a natural gas processing, extraction and fractionation facility located in Henderson County, Texas. Dynegy owns a 33.33 percent in Waskom. Dynegy operates the facility and has commercial responsibility for product distribution and sales.

Barge Co. Barge Co., a Delaware limited liability company, owns pressurized LPG barges used in transporting LPGs principally in the Gulf of Mexico. Dynegy owns a 25 percent interest in Barge Co. At December 31, 1998, the unamortized excess of the Company's investment in Barge Co. over its equity in the underlying net assets of the affiliate approximated \$10 million. This amount is being amortized on the straight-line method over the estimated economic service lives of the underlying assets.

Aggregate equity method investment at December 31, 1998, 1997 and 1996, was \$498.5 million, \$466.4 million and \$177.8 million, respectively. Dividends received on these investments during each of the three years in the period ended December 31, 1998, totaled \$84.0 million, \$63.6 million and \$7.3 million, respectively. Summarized aggregate financial information for these investments and Dynegy's equity share thereof was:

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

	December 31,					
	1998		1997		1996	
	Total	Equity Share	Total	Equity Share	Total	Equity Share
	(\$ in thousands)					
Current assets (1)(2)	\$ 324,462	5 131,169	\$ 283,787	\$ 112,895	\$ 93,949	\$ 35,321
Non-current assets (1)(2)	1,983,731	803,333	1,830,106	736,667	324,210	122,882
Current liabilities (1)(2)	292,481	124,016	202,754	86,476	30,459	11,893
Non-current liabilities (1)(2)	1,160,639	485,673	1,249,874	521,691	47,250	18,309
Operating margin (1)(2)(3)	397,391	159,288	209,877	86,154	37,296	14,500
Net income (1)(2)(3)	157,054	68,706	83,601	33,799	19,024	7,360

1. The financial data for all periods presented is exclusive of amounts attributable to the Company's investment in Accord as disclosure data was unavailable for the current period. Dynegy's share of Accord earnings for each of the three years in the period ended December 31, 1998, totaled \$21.8 million, \$25.9 million and \$18.0 million, respectively.
2. The financial data for all periods presented is exclusive of amounts attributable to the Company's investment in NCL as such information was not comparable period-to-period, as a result of the NCL restructuring. Dynegy sold its interest in NCL effective April 1, 1997. Dynegy's share of NCL's loss for the three months ended March 31, 1997, totaled \$892,000. Dynegy's share of NCL's earnings for the year ended December 31, 1996 totaled \$3.6 million.
3. Equity earnings derived from investments acquired in the Destec acquisition accrue to Dynegy commencing July 1, 1997.

The cost method of accounting is generally used to account for investment in partnerships or companies in which Dynegy has a voting interest of less than 20 percent. At December 31, 1998, the Company had two cost basis investments: **Indeck** North American Power Fund, L.P. and **Indeck** North American Power Partners, L.P. (collectively "Indeck"). **Indeck** is engaged in the acquisition and operation of electric power generating facilities. Dynegy's aggregate investment in these entities totaled \$4.1 million and \$4.0 million at December 31, 1998 and 1997, respectively, and Dynegy received an aggregate \$0.5 million, \$0.5 million and \$0.6 million of dividends from **Indeck** during each of the three years in the period ended December 31, 1998.

Note 6 -- LONG-TERM DEBT

Long-term debt consisted of:

		December 31,	
		1998	1997
(\$ in thousands)			
Commercial Paper	5	518,643	5 229,500
Money market lines of credit		20,000	
Credit Agreement			110,000
Canadian Credit Agreement		40,000	
6.75% Senior Notes, due 2005		150,000	150,000
7.625% Senior Debentures, due 2026		175,000	175,000
7.125% Senior Debentures, due 2018		175,000	
Power Generation Notes		103,126	---
Chevron Note		---	155,373
14% Senior Subordinated Notes, due 2001		---	65,000
10.25% Subordinated Notes, due 2003		---	105,000
Other, non-interest bearing		275	550
Unamortized premium		---	11,906
		1,182,044	1,002,329
		135,154	275
Less: long-term debt due within one year		<u>\$ 1,046,890</u>	<u>\$ 1,002,054</u>

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Commercial Paper and Money Market Lines Of Credit. The Company utilizes commercial paper proceeds and borrowings under uncommitted money market lines of credit for general corporate purposes, including short-term working capital requirements. The commercial paper program is for amounts up to \$800 million, as supported by existing credit agreements. Weighted average interest rates on amounts outstanding under the commercial paper program were 6.1 percent and 6.8 percent at December 31, 1998 and 1997, respectively. Amounts outstanding under the uncommitted money market lines of credit bore interest at an average rate of 6.0 percent at December 31, 1998. The Company classifies outstanding commercial paper and borrowings under money market lines of credit as long-term debt to the extent of availability under existing committed credit facilities, as management's intent is to maintain these obligations for longer than one year, subject to an overall reduction in corporate debt levels.

Credit Agreements. In May 1998, Dynegy refinanced its then existing revolving credit agreement with a \$400 million, five-year revolving credit agreement that matures May 27, 2003, and a \$400 million, 364-day revolving credit agreement maturing in May, 1999 (the "Credit Agreements"). The Credit Agreements provide funding for letters of credit, working capital, capital expenditures and general corporate purposes, including commercial paper support. The Credit Agreements also require payment of various costs and fees, including an annual fee of 0.09 percent of the committed amount under the Credit Agreements. Generally, borrowings under the Credit Agreements bear interest at a Eurodollar rate plus a margin that is determined based on the Company's unsecured senior debt rating. At December 31, 1998, such margin was 0.21 percent. Financial covenants in the Credit Agreements are limited to a debt to capitalization test. Letters of credit under the Credit Agreements aggregated approximately \$27 million at December 31, 1998.

The Company maintains an additional \$240 million, 364-day revolving credit facility having a current maturity date of December 17, 1999. The facility provides funding for general corporate purposes. The facility also requires payment of various costs and fees, including an annual fee of 0.125 percent of the committed amount under the facility. Generally, borrowings under the facility bear interest at a Eurodollar rate plus a margin that is determined based on the Company's unsecured senior debt rating. At December 31, 1998, such margin was 0.525 percent. Financial covenants are limited to a debt to capitalization test. No amounts were outstanding under this agreement at December 31, 1998.

After consideration of the outstanding commercial paper, the unused borrowing capacity under the Credit Agreements and additional 364-day facility approximated \$495 million at December 31, 1998.

Canadian Credit Agreement. In November 1998, an indirect wholly owned Canadian subsidiary of the Company entered into a \$60 million, two-year revolving credit facility, which matures on November 24, 2000 (the "Canadian Credit Agreement"). The Canadian Credit Agreement provides funding for general corporate purposes. The Canadian Credit Agreement requires payment of various costs and fees, including an annual fee of 0.25 percent of the committed amount under the Canadian Credit Agreement. Generally, borrowings under the Canadian Credit Agreement bear interest at a Eurodollar rate plus a margin that is determined based on the Company's unsecured senior debt rating. At December 31, 1998, such margin was 0.40 percent. The Canadian subsidiary's obligations under the Canadian Credit Agreement are fully and unconditionally guaranteed by the Company. At December 31, 1998, outstanding amounts under the facility totaled \$40.0 million, at an average interest rate of 6.09 percent.

6.75% Senior Notes Due 2005. In December 1995, the Company sold \$150 million of 6.75 percent Senior Notes due December 15, 2005 ("Senior Notes"). The Senior Notes were issued at a price of 99.984 percent, which, after deducting underwriting discounts and commissions, resulted in net proceeds to the Company of approximately \$149 million. Proceeds from the sale of the Senior Notes were used to repay a portion of the outstanding indebtedness under the then existing revolving credit agreement. Interest on the Notes is payable semiannually on June 15 and December 15 of each year. Upon issuance, the Senior Notes were priced based on the then existing yield for 10-year U.S. Treasury Notes ("10-Year Base Treasury Rate") plus a spread based principally on the Company's credit rating. Prior to issuing the Senior Notes, the Company entered into two separate transactions with two separate financial institutions, the effect of which was to lock in the 10-Year Base Treasury Rate at approximately 6.2 percent on the full \$150 million face value of the Senior Notes.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

7.625% Senior Debentures Due 2026. In October 1996, Dynegy sold \$175 million of 7.625 percent Senior Debentures due October 15, 2026 ("Senior Debentures"). The Senior Debentures were issued at a price of 99.522 percent, which, after deducting underwriting discounts and commissions, resulted in net proceeds to the Company of approximately \$173 million. The net proceeds from the sale of such Senior Debentures were used to repay a portion of the outstanding indebtedness under the then existing revolving credit agreement. Interest on the Senior Debentures is payable semiannually on April 15 and October 15 of each year. The Senior Debentures are redeemable, at the option of the Company, in whole or in part from time to time, at a formula based redemption price as defined in the associated indenture. Upon issuance, the Senior Debentures were priced based on the then existing yield for 30-year U.S. Treasury Notes ("30-Year Base Treasury Rate") plus a spread based principally on the Company's credit rating. Prior to issuing the Senior Debentures, the Company entered into a transaction, the effect of which was to lock in the 30-Year Base Treasury Rate at approximately 7.0 percent on \$150 million of the \$175 million face value of the Senior Debentures.

In February 1998, the Company completed an amendment to the then existing revolving credit agreement and the filing of supplemental indentures to each of the Senior Debentures and Senior Notes, the effect of which was to eliminate all clauses, provisions and terms in such documents requiring certain wholly owned subsidiaries of the Company to fully and unconditionally guarantee, on a joint and several basis, the obligations of the Company under such credit agreement, debentures and notes, respectively.

7.125% Senior Debentures Due 2018. In May 1998, Dynegy sold \$175 million of 7.125 percent Senior Debentures due May 15, 2018 ("Debentures"). The Debentures were issued at a price of 99.654 percent, which, after deducting underwriting discounts and commissions, resulted in net proceeds of approximately \$173 million. Proceeds from the sale of the Debentures were used to retire short-term debt incurred in connection with the redemption of certain high-cost debt discussed below. Interest on the Debentures is payable semiannually on May 15 and November 15 of each year. The Debentures are redeemable, at the option of the Company, in whole or in part from time to time, at a formula based redemption price as defined in the associated indenture. Upon issuance, the Debentures were priced based on the then existing 30-Year Base Treasury Rate plus a spread based principally on the Company's credit rating. Prior to issuing the Debentures, the Company entered into a series of transactions, the effect of which was to lock in the 30-Year Base Treasury Rate at approximately 6.0% on \$148 million of the \$175 million face value of the Debentures.

Power Generation Notes. Included in the December 31, 1998 consolidated long-term debt balance was \$103.1 million representing the aggregate principal balance outstanding under three separate notes, each having recourse only to the assets of one of the three power generation projects acquired in 1998 as described in Note 4. Each of the three notes represents a fifteen-year term loan obligation payable in semi-annual installments of principal plus accrued interest. Each note bears interest at a base rate plus a margin, as defined in each agreement. Interest rate swaps effectively fix the base rate on \$69.3 million of the indebtedness at a weighted average rate of 8.067 percent.

Retired Debt. During 1998, the Company retired the 14 percent Senior Subordinated Notes, the 10.25 percent Subordinated Notes and the Chevron Note. The retirement of these notes was funded through a combination of borrowings under existing credit agreements and the sale of commercial paper. There was no financial gain or loss related to these retirements.

Aggregate maturities of all long-term indebtedness are: 1999 - \$135.2 million; 2000 - \$40.0 **million**; 2001 - none; 2002 - none; 2003 and beyond \$1.0 billion.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 7 - INCOME TAXES

The Company is subject to U.S. federal, foreign and state income taxes on its operations. Components of income tax expense (benefit) were:

	Year Ended December 31,		
	1998	1997	1996
	(\$ in thousands)		
Current tax expense (benefit):			
Domestic	5 (608)	\$ 13,230	\$ 10,427
Foreign	(1,362)	3,071	---
Deferred tax expense (benefit):			
Domestic	44,565	(8 1,306)	45,510
Foreign	<u>1,743</u>	<u>2,795</u>	<u>386</u>
Income tax provision (benefit)	\$ 50,338	\$ (62,210)	\$ 56,323

Components of income (loss) before income taxes was as follows:

	Year Ended December 31,		
	1998	1997	1996
	(\$ in thousands)		
Income (loss) before income taxes:			
Domestic	5 133,867	\$ (180,127)	5 150,705
Foreign	<u>24,824</u>	<u>30,232</u>	<u>18,940</u>
	\$ 158,691	\$ (149,895)	\$ 169,645

Deferred income taxes are provided for the temporary differences between the tax basis of Dynegy's assets and liabilities and their reported financial statement amounts. Significant components of deferred tax liabilities and assets were:

	December 31,	
	1998	1997
	(\$ in thousands)	
Deferred tax assets:		
Clearinghouse partnership basis differential	\$ 990	5 19,211
Loss carryforward	132,445	76,885
Tax credits	10,798	23,162
Other	<u>144,233</u>	<u>8,499</u>
	144,233	127,757
Valuation allowance	<u>144,233</u>	<u>127,757</u>
Deferred tax liabilities:		
Items associated with capitalized costs	461,770	381,816
Net deferred tax liability	\$ 317,537	\$ 254,059

Realization of the aggregate deferred tax asset is dependent on the Company's ability to generate taxable earnings in the future. There was no valuation allowance established at December 31, 1998 or 1997, as management believes the aggregate deferred asset is more likely than not to be fully realized in the future.

Income tax provision (benefit) for the years ended December 31, 1998, 1997 and 1996, was equivalent to effective rates of 32 percent, (41) percent and 33 percent, respectively. Differences between taxes computed at the U.S. federal statutory rate and the Company's reported income tax provision (benefit) were:

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	Year Ended December 31,		
	1998	1997	1996
	(\$ in thousands)		
Expected tax at U.S. statutory rate	\$ 55,444	\$ (52,463)	5 59,376
state taxes	2,564	(3,676)	3,393
Foreign tax benefit	(2,300)	(5,415)	(6,621)
Basis differentials and other	15,370	(656)	175
Income tax provision (benefit)	\$ 50,338	\$ (62,210)	\$ 56,323

At December 31, 1998, the Company had approximately \$358 million of regular tax net operating loss carryforwards. The net operating loss carryforwards expire from 2006 through 2012. Certain provisions of the Internal Revenue Code place an annual limitation on the Company's ability to utilize tax carryforwards existing as of the date of a 1995 business acquisition. Management believes such carryforwards will be fully realized prior to expiration.

Note 8 -- COMPANY OBLIGATED PREFERRED SECURITIES OF A SUBSIDIARY TRUST

In May 1997, NGC Corporation Capital Trust I ("Trust") issued, in a private transaction, \$200 million aggregate liquidation amount of 8.316% Subordinated Capital Income Securities ("Trust Securities") representing preferred undivided beneficial interests in the assets of the Trust. The Trust invested the proceeds from the issuance of the Trust Securities in an equivalent amount of 8.3 16% Subordinated Debentures ("Subordinated Debentures") of the Company. The sole assets of the Trust are the Subordinated Debentures. The Trust Securities are subject to mandatory redemption in whole but not in part on June 1, 2027, upon payment of the Subordinated Debentures at maturity, or in whole but not in part at any time, contemporaneously with the optional prepayment of the Subordinated Debentures, as allowed by the associated indenture. The Subordinated Debentures are redeemable, at the option of the Company, in whole at any time or in part from time to time, at formula-based redemption prices, as defined in the indenture. The Subordinated Debentures represent unsecured obligations of the Company and rank subordinate and junior in right of payment to all Senior Indebtedness to the extent and in the manner set forth in the associated indenture. The Company has irrevocably and unconditionally guaranteed, on a subordinated basis, payment for the benefit of the holders of the Trust Securities the obligations of the Trust to the extent the Trust has funds legally available for distribution to the holders of the Trust Securities, as described in the indenture ("Guarantee"). Distributions on the Trust Securities are payable each June 1 and December 1, coinciding with the interest payment due dates on the Subordinated Debentures, and are classified in the accompanying Statement of Operations as "minority interest in income of a subsidiary." The periodic distributions accruing at an annual rate of 8.3 16 percent of the aggregate liquidation amount are recorded as minority interest in income of a subsidiary in the Company's consolidated statement of operations. So long as no Debenture Event of Default, as defined, has occurred and continues, the Company has the right to defer the payment of interest on the Subordinated Debentures for any Extension Period elected by the Company, which period cannot extend beyond 10 consecutive semi-annual periods, end on a date other than an Interest Payment Date or extend beyond the Stated Maturity Date. During October 1997, the Trust completed an exchange offer through which all of the outstanding Trust Securities were exchanged by the holders thereof for registered securities having substantially the same rights and obligations.

Note 9 -- COMMITMENTS AND CONTINGENCIES

Litigation. On April 17, 1997, Pacific Gas and Electric Company ("PG&E") filed a lawsuit in the Superior Court of the State of California, City and County of San Francisco, against Destec, Destec Holdings, Inc. and Destec Operating Company (wholly-owned subsidiaries of the Company now known respectively as Dynegy Power Corp., Dynegy Power Holdings, Inc. and Dynegy Operating Company) as well as against San Joaquin CoGen Limited ("San Joaquin" or the "Partnership") and its general partners (collectively the "Dynegy Defendants"). Dynegy Power Corp. and its affiliates now own all of the partnership interests in the Partnership as a result of the purchase of the interests of the two outside partners in the Partnership. In the lawsuit, PG&E asserts claims and alleges unspecified damages for fraud, negligent misrepresentation, unfair business practices, breach of contract and breach of the implied covenant of good faith and fair

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dealing. PG&E alleges that due to the insufficient use of steam by San Joaquin's steam host, the Partnership did not qualify as a cogenerator pursuant to the California Public Utilities Code ("CPUC") Section 218.5, and thus was not entitled under CPUC Section 454.4 to the discount the Partnership received under gas transportation agreements entered into between PG&E and San Joaquin in 1989, 1991, 1993 and 1995. All of PG&E's claims in this suit arise out of the Partnership's alleged failure to comply with CPUC Section 218.5. The defendants filed a response to the suit on May 15, 1997. On October 20, 1997, PG&E named Libbey-Owens-Ford ("LOF"), the Partnership's steam host, as an additional defendant in the action. On February 23, 1998, PG&E served its Second Amended Complaint on all defendants. On March 30, 1998, the defendants filed their response to PG&E's Second Amended Complaint, denying PG&E's allegations and alleging certain counterclaims against PG&E. By Order dated July 20, 1998, the court dismissed certain of defendants' counterclaims against PG&E, and abated certain others, pending resolution by the CPUC. The trial date is currently June 15, 1999. The Partnership has previously advised the FERC of PG&E's claims, and stated that it would submit any appropriate filings upon completion of its investigation. If the facility was found not to have satisfied the California cogeneration facility standards, there is a strong likelihood that it would also fail to satisfy the more stringent federal standards. In accordance with the terms of a Protective Order entered into by the parties at the commencement of the litigation, PG&E has notified San Joaquin that it may make a FERC filing seeking damages from San Joaquin and decertification of its status as a qualifying facility under the federal standards. Under FERC precedent, if the San Joaquin facility were found not to have been a qualifying facility, San Joaquin could be required to refund to PG&E payments it received pursuant to the Power Purchase Agreement in excess of PG&E's short-term energy costs during the period of non-compliance, plus interest. In the event the court or FERC were to determine that San Joaquin is liable to PG&E under the Gas Transportation Agreement or Power Purchase Agreement due to LOF's failure to use sufficient quantities of steam, San Joaquin will seek to recover such amounts from LOF under the terms of the Steam Purchase Agreement between San Joaquin and LOF. The parties have been actively engaged in settlement discussions, which resulted in the execution of a Termination and Settlement Agreement between PG&E and the Dynegy Defendants on March 9, 1999 (the "Settlement Agreement"). The Settlement Agreement provides for, upon the receipt of CPUC approval, a dismissal with prejudice of PG&E's claims against the Dynegy Defendants, a release by PG&E of all claims relative to FERC matters and a termination of the San Joaquin power purchase agreement as of December 31, 1999, whereupon the San Joaquin facility will continue to operate as a merchant plant. The Dynegy Defendants will seek to recover from LOF any losses resulting from the settlement with PG&E. However, if the settlement is not ultimately concluded, the Dynegy Defendants will seek to recover from LOF any losses or amounts for which it may be found liable. Further, the Company's subsidiaries intend to continue to vigorously defend this action. In the opinion of management, the ultimate resolution of this lawsuit will not have a material adverse effect on the Company's financial position or results of operations.

On March 24, 1995, Southern California Gas Company ("SOCAL") filed a lawsuit in the Superior Court of the State of California for the County of Los Angeles, against Destec, Destec Holdings and Destec Gas Services, Inc. (now known respectively as Dynegy Power Corp., Dynegy Holdings, Inc. and Dynegy Gas Services, Inc.), wholly-owned direct and indirect subsidiaries of the Company (collectively, the "Defendants"), as well as against Chalk Cliff Limited and McKittrick Limited (collectively, the "Partnerships"). The Company owns an indirect 50 percent limited partnership interest in McKittrick Limited, and Chalk Cliff Limited is now wholly owned by subsidiaries of the Company through the purchase of the interests of Dominion Energy, Inc. All general partners of the Partnerships are also named defendants. The lawsuit alleged breach of contract against the Partnerships and their respective general partners, and interference and conspiracy to interfere with contracts against the Defendants. The breach of contract claims arose out of the "transport-or-pay" provisions of the gas transportation service agreements between the Partnerships and SOCAL. SOCAL sought damages from the Partnerships for past damages and anticipatory breach damages in an amount equal to approximately \$3 1,000,000. On October 24, 1997, the Court granted SOCAL's Motion for Summary Judgment relating to the breach of contract causes of action against the Partnerships and their respective general partners, and requested that SOCAL submit a proposed order consistent with that ruling for the Court's signature. On November 21, 1997, the Partnerships filed for voluntary Chapter 11 bankruptcy protection in the Eastern District of California. Normal business operations by the Partnerships continued throughout the course of these reorganization proceedings. On January 12, 1998, the Court entered a Final Order that (a) severed out the Partnerships due to their Chapter 11 bankruptcy filings, (b) included a finding of contract liability against the Defendants, (c) dismissed the tortious interference claims against the Defendants, and (d) assessed damages in an aggregate amount of approximately \$3 1,000,000. On the same day, the Defendants filed their Notice of Appeal, and posted a security bond with the Second Appellate District in Los Angeles based on the lack of allegations made or proven by SOCAL which support holding those entities liable in contract. On March 11, 1998, the Partnerships and their respective general partners filed Notices of Appeal with respect to certain findings of fact in the

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Court's January 12, 1998 Final Order that were adverse to those defendants. On or about April 15, 1998, the Court entered a final judgment against the Partnerships themselves in recognition of the lifting of the automatic stay against those entities by the Bankruptcy Court. The Partnerships filed their appeal of that final judgment on June 4, 1998. On October 21, 1998, the Bankruptcy Court dismissed the voluntary bankruptcy filings of the Partnerships and their respective lenders thereafter notified each of the Partnerships of the occurrences of an Event of Default under the Partnerships' respective credit agreements due to the existence of the **SOCAL** judgment against them, and have instituted foreclosure proceedings as to the projects. Additionally, receivers were named by the lenders and approved by the Court for each of the projects. In early December 1998, the defendants filed their opening appellate briefs in the appeal of the Court's final judgment. On February 23, 1999, the Court granted a motion by **SOCAL** to amend the Court's final judgment to include a finding that Dynegy Power Corp. is the alter ego of the Partnerships and their respective general partners. Dynegy Power Corp. will appeal the Court's ruling, and will vigorously defend **SOCAL**'s claims.

The **PG&E** and **SOCAL** litigations represent pre-acquisition contingencies acquired by the Company in the Destec Acquisition. In a related matter, Chalk Cliff and San Joaquin have each guaranteed the obligations of the other partnership, represented by the project financing loans used to construct the power generation facilities owned by the respective Partnerships. In the opinion of management, the election by the lender of its option under the terms of such arrangements would not have a material adverse effect on the Company's financial position or results of operations.

On August 3, 1998, Modesto Irrigation District ("MID") filed a lawsuit against **PG&E** and Destec in federal court for the Northern District of California, San Francisco division. The lawsuit alleges violation of federal and state antitrust laws and breach of contract against Destec. The allegations are related to a power sale and purchase arrangement in the city of Pittsburg, CA. MID seeks actual damages from **PG&E** and Destec in amounts not less than \$25 million. MID also seeks a trebling of any portion of damages related to its antitrust claims. By order dated February 2, 1999, the federal District Court dismissed MID's state and federal antitrust claims against **PG&E** and Destec; however, the Court granted MID leave of thirty days to amend its complaint to state an antitrust cause of action. On March 3, 1999, MID filed an amended complaint recasting its federal and state antitrust claims against **PG&E** and Destec and restating its breach of contract claim against Destec. Dynegy believes the allegations made by MID are meritless and will continue to vigorously defend MID's claims. In the opinion of management, the amount of ultimate liability with respect to these actions will not have a material adverse effect on the financial position or results of operations of the Company.

The Company assumed liability for various claims and litigation in connection with the Chevron Combination, the Trident Combination, the Destec Acquisition and in connection with the acquisition of certain gas processing and gathering facilities from Mesa Operating Limited Partnership. The Company believes, based on its review of these matters and consultation with outside legal counsel, that the ultimate resolution of such items will not have a material adverse effect on the Company's financial position or results of operations. Further, the Company is subject to various legal proceedings and claims, which arise in the normal course of business. In the opinion of management, the amount of ultimate liability with respect to these actions will not have a material adverse effect on the financial position or results of operations of the Company.

Commitments. In conducting its operations, the Company routinely enters into long-term commodity purchase and sale commitments, as well as agreements that commit future cash flow to the lease or acquisition of assets used in its businesses. These commitments are typically associated with capital projects, reservation charges associated with firm transmission, transportation and storage capacity, lease agreements for ship charters and other distribution assets and leases for office space, equipment and other similar items. The following describes the more significant commitments outstanding at December 31, 1998.

A subsidiary of the Company has entered into binding agreements committing the Company to expend approximately \$14 million for the acquisition of combustion turbine generators and related equipment. This equipment will be used in the construction of electricity generating capacity in selected sites throughout the U.S. A significant portion of the current commitment relates to agreements that include cancellation provisions providing for termination at Dynegy's option during the construction phase in exchange for variable penalty payments.

In 1997, Dynegy received cash from a gas purchaser as an advance payment for future natural gas deliveries over a ten-year period ("Advance Agreement"). As a condition of the Advance Agreement, Dynegy entered into a natural gas swap with a third party under which Dynegy became a fixed-price payor on identical volumes to those to be

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delivered under the Advance Agreement at prices based on then current market rates. The cash payment was classified as an advance on the balance sheet and is ratably reduced as gas is delivered to the purchaser under the terms of the Advance Agreement. In addition, ~~the~~ purchaser pays a monthly fee to Dynegy associated with delivered volumes. The Advance Agreement contains certain non-performance penalties that impact both parties and as a condition precedent. Dynegy purchased a surety bond in support of its obligations under the Advance Agreement.

For a two-year period beginning January 1, 1998, the Company contracted for 1.3 billion cubic feet per day of firm transportation capacity to California on the El Paso Natural Gas pipeline system. Pursuant to this arrangement, Dynegy is obligated to pay a minimum of \$38 million of reservation charges during 1999.

A wholly owned subsidiary of the Company leases certain power generating assets under agreements that are classified as operating leases. These agreements have aggregate future minimum lease payments of approximately \$432 million at December 31, 1998.

Minimum commitments in connection with office space, equipment, reservation charges under purchase and firm transportation contracts, power generating and other leased assets were: 1999 \$134.4 million; 2000 - \$232.6 million; 2001 - \$239.0 million; 2002 - \$29.0 million; and 2003 and beyond - \$99.6 million. Rental payments made under the terms of these arrangements totaled - \$126.1 million in 1998, \$85.2 million in 1997 and \$45.2 million in 1996.

Note 10 -- CAPITAL STOCK

The Company has authorized capital stock consisting of 450,000,000 shares, of which 50,000,000 shares, par value \$0.01 per share, are designated preferred stock and 400,000,000 shares, par value \$0.01 per share, are designated common stock.

Preferred Stock. The Company's preferred stock may be issued from time to time in one or more series, the shares of each series to have such designations and powers, preferences, rights, qualifications, limitations and restrictions thereof as described in the Company's Certificate of Incorporation. In order to provide for issuance of preferred shares pursuant to the terms of the Chevron Combination, 8,000,000 shares of preferred stock were designated during 1996 as Dynegy Series A Participating Preferred Stock ("Series A Preferred"), of which 7,815,363 shares were issued effective September 1, 1996.

Except as provided by law, the holders of the Series A Preferred have no voting rights and such shares are not redeemable. At the holders option, each share of the Series A Preferred may be converted, subject to certain adjustments and certain defined conditions precedent, into one share of Dynegy common stock. Such shares have certain preferences, as defined, in the event of liquidation or dissolution of Dynegy over all stock having a junior ranking. Subject to certain anti-dilutive adjustments, as defined, the holders of the Series A Preferred are entitled to receive dividends or distributions equal per share in amount and kind to any dividend or distribution payable on shares of the Company's common stock, when and as the same are declared by the Company's Board of Directors out of funds legally available therefor and paid to the holders of the Company's common stock. Beginning in the third quarter of 1996, the Company paid quarterly cash dividends on the Series A Preferred of \$0.0125 per share, or \$0.05 per share on an annual basis.

Common Stock. At December 31, 1998, there were 153,298,220 shares of common stock issued. Dynegy pays quarterly cash dividends on common stock of \$0.0125 per share, or \$0.05 per share on an annual basis.

In May 1997, the Board of Directors approved a stock repurchase program that allows the Company to repurchase, from time to time, up to 1.6 million shares of common stock in open market transactions. The timing and number of shares ultimately repurchased will depend upon market conditions and consideration of alternative investments. Pursuant to this program, the Company has acquired 1,200,700 shares at a total cost of \$17.4 million, or \$14.50 per share on a weighted average cost basis, through December 31, 1998.

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Stock Warrants. At December 31, 1998, the Company had warrants outstanding that entitle the holder thereof to purchase an aggregate 6.228 shares of common stock at an exercise price of \$8.13 per share. The warrants expire in October 2003.

Stock Options. Each option granted is valued at an option price, which ranges from \$2.03 per share to the fair market value per share at date of grant. The difference between the option price and the fair market value, if any, of each option on the date of grant is recorded as compensation expense over a vesting period. Options granted at prices below fair market do not become exercisable until the fifth anniversary date of the grant, at which time they become fully exercisable. Options granted at market value vest and become exercisable ratably over a three-year period. The average exercise price of vested options at December 31, 1998 was \$2.69. Compensation expense related to options granted totaled \$4.7 million, \$4.0 million and \$2.8 million for the years ended December 31, 1998, 1997 and 1996, respectively.

At December 31, 1998, employee stock options aggregating 4.4 million shares were exercisable at prices ranging from \$2.03 to \$21.63 per share. Employee stock option grants made from 1994 to 1998 will become exercisable during 1999 and 2000, respectively, resulting in the potential exercise of approximately 9.6 million options during that two-year period, at exercise prices ranging from \$2.03 to \$21.63. Other options currently granted under the Company's option plans will fully vest periodically and become exercisable through the year 2003 at prices ranging from \$2.03 to \$21.63. Grants made under the Company's option plans may be canceled under certain circumstances as provided in the plans. While the Company cannot predict the timing or the number of shares which may be issued upon the exercise of option grants by individual employees, the Company is pursuing a variety of alternatives to help assure an orderly distribution of shares which may become available to the market. Stock option transactions for 1998, 1997 and 1996 were (shares in thousands):

	Year Ended December 31,					
	1998		1997		1996	
	Shares	Option Price	Shares	Option Price	Shares	Option Price
Outstanding at beginning of period	14,015	\$ 2.03 - 21.63	13,920	\$ 2.03 - 18.75	12,615	\$ 2.03 - 9.38
Granted	7,319	2.03 - 17.50	2,284	2.03 - 21.63	1,842	2.03 - 18.75
Exercised	(995)	2.03 - 9.38	(1,469)	2.03 - 9.38	(737)	2.03 - 9.38
Canceled or expired	(1,568)	2.03 - 19.00	(629)	2.03 - 18.75	(313)	2.03 - 9.38
Other, contingent share issuance	(92)	2.03 - 5.66	(91)	2.03 - 5.66	513	2.03 - 8.13
Outstanding at end of period	<u>18,679</u>	<u>\$ 2.03 - 21.63</u>	<u>14,015</u>	<u>\$ 2.03 - 21.63</u>	<u>13,920</u>	<u>\$ 2.03 - 18.75</u>
Exercisable at end of period	<u>4,394</u>	<u>\$ 2.03 - 21.63</u>	<u>2,861</u>	<u>\$ 2.03 - 18.75</u>	<u>469</u>	<u>\$ 2.03 - 9.38</u>
Weighted average fair value of Options granted during the period						
At market		\$ 5.77		\$ 11.14		\$ 15.20
Weighted average fair value of Options granted during the period						
At below market		\$ 7.35		\$ 14.63		\$ 21.38

The fair value of each option grant was estimated on the date of grant using the Black-Scholes option-pricing model, with the following weighted-average assumptions used for grants in 1998, 1997 and 1996: dividends per year of \$0.05 per annum for all years; expected volatility of 40.1 percent, 42.0 percent and 43.3 percent, respectively; risk-free interest rate of 6.28 percent, 6.28 percent and 5.9 percent, respectively; and an expected life of 10 years for all periods. The Company accounts for its stock option plan in accordance with Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees". Had compensation cost been determined consistent with SFAS No. 123, "Accounting for Stock-Based Compensation" ("SFAS No. 123"), the Company's net income (loss) and per share amounts would have approximated the following pro forma amounts for the years ended December 31, 1998, 1997 and 1996, respectively.

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	Years Ended December 31,					
	1998		1997		1996	
	Net Income	Diluted EPS	Net Loss	Loss Per Share	Net Income	Diluted EPS
	(\$ in thousands, except per share data)					
Pro forma amounts	\$ 104,578	\$ 0.63	\$ (108,007)	\$ (0.72)	\$ 107,580	\$ 0.79

As allowed by the transitional disclosure requirements of SFAS No. 123, the preceding pro forma net income and pro forma EPS amounts do not include the impact, if any, of applying the accounting methodology of SFAS No. 123 to options granted prior to January-1, 1995. As a result, the compensation cost included in the pro forma net income amounts for each of the three years in the period ended December 31, 1998, may not be indicative of amounts to be expected in future periods.

Note 11 -- BUSINESS COMBINATIONS AND SIGNIFICANT RESTRUCTURINGS

The Destec Acquisition. On June 27, 1997, Dynegy acquired Destec Energy, Inc. ("Destec"), an independent power producer, for \$1.26 billion, or \$21.65 per share of Destec common stock. Dynegy financed the transaction through cash on hand and advances on its credit facilities provided by its existing commercial banks. Concurrent with this acquisition, Dynegy sold Destec's international facilities and operations to The AES Corporation ("AES") for \$439 million. Also during 1997, the Company sold certain non-strategic assets acquired in the purchase for aggregate proceeds of \$296 million. Proceeds from the AES and non-strategic asset sales were used to retire indebtedness.

The Destec acquisition was accounted for under the purchase method of accounting. Accordingly, the purchase price of approximately \$718 million, inclusive of transaction costs and net of cash acquired, was allocated to the Destec assets acquired and liabilities assumed based on their estimated fair values as of June 30, 1997, the effective date of the acquisition for accounting purposes. The results of operations of the acquired Destec assets are consolidated with Dynegy's existing operations beginning July 1, 1997. The following table reflects certain unaudited pro forma information for the periods presented as if the Destec acquisition had occurred on January 1, 1996 (in thousands, except per share data):

	Years Ended December 31,	
	1997	1996
Pro forma revenues	\$ 13,498,207	\$ 7,529,928
Pro forma net income (loss)	(101,175)	125,962
Pro forma earnings (loss) per share	(0.67)	0.93

Restructuring of Novagas Clearinghouse, Ltd. In June 1997, the Company and NOVA Corporation ("NOVA") completed the restructuring of the companies' Canadian natural gas operations formerly executed through Novagas Clearinghouse, Ltd., Novagas Clearinghouse Limited Partnership and Novagas Clearinghouse Pipelines Limited Partnership (collectively "NCL"), a joint venture between Dynegy and NOVA. Pursuant to the agreements, Dynegy Canada Inc. ("DCI"), a wholly owned indirect subsidiary of Dynegy, acquired NCL's natural gas marketing business, excluding the natural gas aggregation business of Pan-Alberta Gas Ltd. ("Pan-Alberta"), from NCL and sold its aggregate 49.9 percent interest in NCL to NOVA Gas International ("NGI"), a subsidiary of NOVA. NOVA assumed full ownership of NCL's gathering and processing business and the operations of Pan-Alberta. The restructuring included amendments to or termination of various agreements between NCL, Dynegy, NOVA and certain affiliates of both Dynegy and NOVA. Dynegy realized a pretax gain on the sale of its interest in NCL of \$7.8 million, which is classified as other income in the accompanying consolidated statements of operations for the year ended December 31, 1997. The acquisition by Dynegy of NCL's marketing business was accounted for under the purchase method of accounting. Accordingly, the purchase price of \$4.0 million, inclusive of transaction costs, was allocated to the assets acquired and liabilities assumed based on their estimated fair values as of April 1, 1997, the effective date of the acquisition for accounting purposes.

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Restructuring Of Accord Energy Limited ("Accord"). In early 1997, British Gas completed a restructuring whereby Centrica plc ("Centrica") was demerged from British Gas and British Gas was renamed BG plc ("BG"). Centrica became the Company's joint venture partner in Accord. BG holds the approximate 26 percent stake in Dynegy's common stock formerly held by British Gas. On May 2, 1997, Centrica and the Company completed a restructuring of Accord by converting certain common stock interests in Accord to participating preferred stock interests as of an effective date of January 1, 1997. Centrica and the Company own 75 percent and 25 percent, respectively, of the outstanding participating preferred stock shares of Accord. The participating preferred stock has (a) the right to receive cumulative dividends on a priority basis to other corporate distributions by Accord, and (b) limited voting rights. In addition, Centrica has an option to purchase the Company's participating preferred stock interest at any time after July 1, 2000, at a formula based price, as defined in the agreement. As part of the reorganization, Centrica will operate Accord while Dynegy obtained the right to market natural gas, gas liquids and crude oil in the United Kingdom, which occurs through its wholly owned subsidiary Dynegy UK Limited ("Dynegy UK"). In addition, as part of the restructuring, Dynegy UK acquired Accord's existing crude oil marketing business effective July 1, 1997. No gain or loss was recognized as a result of this restructuring and Dynegy's investment in Accord continues to be accounted for under the equity method.

The Chevron Combination. On August 31, 1996, Dynegy completed a strategic combination (the "Chevron Combination") with Chevron U.S.A. Inc. and certain Chevron affiliates ("Chevron") pursuant to which Chevron contributed substantially all of its midstream assets (the "Contribution"), including substantially all of the assets comprising Warren Petroleum Company and Chevron's Natural Gas Business Unit and an undivided interest in those assets that constitute the West Texas LPG Pipeline, into Midstream Combination Corp. ("Midstream"), a Delaware corporation formed for purposes of the transaction. Dynegy was merged with and into Midstream immediately following the Contribution and Midstream was renamed Dynegy Corporation. In exchange for the Contribution, Chevron received approximately 38.6 million shares of Dynegy common stock and approximately 7.8 million shares of Dynegy Series A Participating Preferred Stock and Dynegy assumed approximately \$283 million of indebtedness. Immediately following closing of the Chevron Combination, Dynegy paid approximately \$128 million to Chevron and funded such payment under its Credit Agreement. The Chevron Combination was accounted for as an acquisition of assets under the purchase method of accounting. The purchase price of approximately \$740 million, inclusive of assumed indebtedness and transaction costs, was allocated to the assets acquired and liabilities assumed based on their estimated fair values as of an effective date of September 1, 1996.

Note 12 -- IMPAIRMENT, ABANDONMENT AND OTHER CHARGES

During the fourth quarter of 1997, the Company recognized a \$275 million charge principally related to impairment of certain long-lived assets, abandonment of certain operating assets and reserves for obsolescence, contingencies and other obligations. The charge primarily resulted from the completion of a plan of restructuring of the Company's natural gas liquids and crude oil businesses, which includes rationalization and consolidation of assets acquired in both the Trident and Chevron Combinations, and the pursuit of a joint venture partner in order to achieve critical mass in its crude oil marketing business. In addition, a company-wide reorganization of reporting responsibilities and improvements in business processes and computer information systems resulted in the identification during the fourth quarter of 1997 of other obsolete assets and a reduction of employees involved in non-strategic operations.

The charge, which was substantially non-cash *in nature*, consisted of the following (*in* thousands):

Abandonment of long-lived operating assets	\$ 154,984
Impairment of operating assets and intangibles	79,550
Inventory obsolescence reserve and write-off	10,340
Write-off of other obsolete assets	12,011
Contingency and other obligation reserves	16,750
Severance charge	1,365
	<u>\$275,000</u>

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The fair values of the assets impaired and abandoned were determined using a discounted cash flow methodology. During 1998, Management substantially completed its plan of rationalization, reorganization and abandonment of assets anticipated at the end of 1997. In addition, pursuant to the execution of the restructuring plan, a charge of \$9.6 million related to severance charges was recognized in the first quarter of 1998. The severance charge was related to the termination of approximately 200 corporate and field employees. The charge recognized in the first quarter of 1998 approximated the actual severance expenditures.

Also during the fourth quarter of 1997, the Company changed its method for accounting for certain business process re-engineering and information technology transformation costs pursuant to a consensus reached in November 1997 by the EITF. The EITF concluded that all re-engineering costs, including those incurred in connection with a software installation, should be expensed as incurred. The Company had previously capitalized certain re-engineering costs and was amortizing such costs over the estimated useful lives of the projects. The cumulative effect of this change in accounting of \$14.8 million represented the one-time charge for the aggregate unamortized re-engineering costs previously capitalized.

Note 13 -- EMPLOYEE COMPENSATION, SAVINGS AND PENSION PLANS

Corporate Incentive Plan. Dynegy maintains a discretionary incentive plan to provide employees competitive and meaningful rewards for reaching corporate and individual objectives. Specific rewards are at the discretion of the Compensation Committee of the Board of Directors ("Compensation Committee").

Profit Sharing/Savings Plan. The Company established the Dynegy Profit Sharing/401(k) Savings Plan ("Plan"), which meets the requirements of Section 401(k) of the Internal Revenue Code, and is a defined contribution plan subject to the provisions of the Employee Retirement Income Security Act of 1974. The Plan and related trust fund are established and maintained for the exclusive benefit of participating employees in the United States and certain expatriates. Similar plans are available to other employees resident in foreign countries subject to the laws of each country. All eligible employees may participate in the plans and employee contributions are generally matched dollar-for-dollar for the first 5 percent of compensation, subject to Company performance. Employees vest in the Company's contributions over various periods. The Company also makes profit sharing contributions to employees' accounts regardless of their individual participation in the Profit Sharing/Savings Plans.

Matching contributions to the Plan and certain discretionary profit sharing contributions are made in Company common stock, other contributions are made in cash. During the years ended December 31, 1998, 1997 and 1996, Dynegy recognized aggregate costs related to these employee compensation plans of \$12.9 million, \$9.7 million and \$5.3 million, respectively.

Pension Plan. Through a business acquisition, the Company acquired a noncontributory defined benefit pension plan and such plan remains in existence at December 31, 1998. The Trident NGL, Inc. Retirement Plan ("Retirement Plan") is a qualified plan under the Internal Revenue Service regulations. The Retirement Plan is closed to new participants. Benefits are based on years of service and final average pay, as defined in the Retirement Plan document. Contributions to the Retirement Plan in 1998 and 1997 represent the minimum amount required by federal law and regulation. The Retirement Plan's funded status and amount recognized in Dynegy's balance sheet at December 31, 1998 and 1997, were:

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	December 31,	
	1998	1997
	(\$ in thousands)	
Projected benefit obligation, beginning of the year	\$ 9,378	\$ 8,909
Service cost	665	711
Interest cost	722	686
Actuarial (gain) loss	1,137	(807)
Benefits paid	(147)	(121)
Projected benefit obligation, end of the year	\$ 11,755	\$ 9,378
Fair value of plan assets, beginning of the year	\$ 8,480	\$ 5,798
Actual return on plan assets	615	1,746
Employer contributions	397	1,057
Benefits paid	(147)	(121)
Fair value of plan assets, end of the year	\$ 9,345	\$ 8,480
Funded status	\$ 2,410	\$ 898
Unrecognized net gain from past experience different from that assumed	3,668	5,025
Pension liability	\$ 6,078	\$ 5,923

Current year pension expense is based on measurements of the projected benefit obligation and the market related value of the Retirement Plan assets as of the end of the year. The projected benefit obligation at December 31, 1998, was based on a discount rate of 7.00 percent and an average long-term rate of compensation growth of 3.5 percent. The expected long-term rate of return on the Retirement Plan assets was estimated at 8.0 percent.

The components of net pension expense for the Retirement Plan were:

	Years Ended December 31,	
	1998	1997
	(\$ in thousands)	
Service cost benefits earned during period	\$ 665	\$ 712
Interest cost on projected benefit obligation	122	686
Expected return on plan assets	(618)	(502)
Amortization of unrecognized gain	(218)	(115)
Net periodic pension cost	\$ 551	\$ 781

Note 14 -- RELATED PARTY TRANSACTIONS

The Company is a leading North American marketer of natural gas, electricity, coal, natural gas liquids, crude oil, liquid petroleum gas and related services. Dynegy is also engaged in natural gas gathering, processing, fractionation and transportation and electric power generating activities. The Company has operations in Canada and the United Kingdom and transports liquid petroleum gas through its *international deepwater* LPG business. The Company routinely transacts business directly or indirectly with three of its significant shareholders, Chevron, NOVA and BG, each of which owns approximately 26 percent of the outstanding shares of the Company's common stock. Chevron holds all of the outstanding shares of the Series A Preferred.

Transactions between the Company and Chevron result principally from the ancillary agreements entered into as part of the Chevron Combination. Transactions between Dynegy, NOVA and BG result from purchases and sales of natural gas, natural gas liquids and crude oil between subsidiaries of Dynegy and these companies. It is management's opinion that these transactions are executed at prevailing market rates. During the years ended December 31, 1998, 1997 and 1996, the Company recognized in its statement of operations aggregate sales to, and aggregate costs from, these significant shareholders of \$888 million and \$1.7 billion, \$788.9 million and \$2.4 billion; and \$286.7 million and \$1.1 billion, respectively.

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Note 15 -- SEGMENT INFORMATION

The Company has adopted Financial Accounting Standard No. 13 I, "Disclosures about Segments of an Enterprise and Related Information" and has restated its segment disclosures for all reporting periods. Dynegy's operations are divided into two reportable segments: Wholesale Gas and Power and Liquids. The Wholesale Gas and Power segment is actively engaged in value creation through marketing and trading of natural gas, power and coal and the generation of electricity principally under the name Dynegy Marketing and Trade. The Liquids segment consists of the North America mid-stream liquids operations, as well as the international liquefied petroleum gas transportation and natural gas liquids marketing operations located in Houston and London, and certain other businesses. The North American mid-stream liquids operations are actively engaged in the gathering and processing of natural gas and the transportation, fractionation and storage of NGLs. This segment operates principally under the name Dynegy Mid-Stream Services. Generally, Dynegy accounts for intercompany transactions at prevailing market rates. Operating segment information for 1998, 1997 and 1996 is presented below.

DYNEGY'S SEGMENT DATA FOR THE YEAR ENDED DECEMBER 31, 1998

	Wholesale Gas and Power	Liquids	Elimination	Total
	(\$ in thousands)			
Unaffiliated revenues:				
Domestic	\$ 9,149,299	\$ 3,307,320	\$ ---	\$ 12,456,619
Canadian	969,853	209,830	---	1,179,683
United Kingdom	621,695	---	---	621,695
	<u>10,740,847</u>	<u>3,517,150</u>	<u>---</u>	<u>14,257,997</u>
Intersegment revenues				
Domestic	157,492	250,280	(407,772)	---
Canadian	61,223	---	(61,223)	---
United Kingdom	---	---	---	---
	<u>218,715</u>	<u>250,280</u>	<u>(468,995)</u>	<u>---</u>
Total revenues	<u>10,959,562</u>	<u>3,767,430</u>	<u>(468,995)</u>	<u>14,257,997</u>
Operating margin	236,238	192,449	---	428,687
Depreciation and amortization	(29,026)	(84,176)	---	(113,202)
Interest expense	(24,944)	(50,048)	---	(74,992)
Interest and other income	6,763	40,058	---	46,821
Equity earnings of unconsolidated affiliates	75,242	15,796	---	91,038
Income tax (provision) benefit	(52,262)	1,924	---	(50,338)
Net income from operations	90,750	17,603	---	108,353
Cumulative effect of change in accounting principle	---	---	---	---
Net income	90,750	17,603	---	108,353
Identifiable assets:				
Domestic	\$ 2,838,367	\$ 2,036,795	\$ ---	\$ 4,875,162
Canadian	257,070	6,947	---	264,017
United Kingdom	125,058	---	---	125,058
Investment in unconsolidated affiliates	343,819	175,863	---	519,682
Capital expenditures	359,516	118,948	---	478,464

DYNEGY INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DYNEGY'S SEGMENT DATA FOR THE YEAR ENDED DECEMBER 31, 1997

	Wholesale Gas and Power	Liquids	Elimination	Total
	(\$ in thousands)			
Unaffiliated revenues:				
Domestic	\$ 8,070,692	\$ 4,205,759	\$...	\$ 12,276,451
Canadian	632,411	264,028	---	896,439
United Kingdom	205,490	---	---	205,490
	<u>8,908,593</u>	<u>4,469,787</u>	<u>---</u>	<u>13,378,380</u>
Intersegment revenues				
Domestic	83,944	437,567	(521,511)	---
Canadian	30,580	---	(30,580)	---
United Kingdom	1,314	---	(1,314)	---
	<u>115,838</u>	<u>437,567</u>	<u>(553,405)</u>	<u>---</u>
Total revenues	<u>9,024,431</u>	<u>4,907,354</u>	<u>(553,405)</u>	<u>13,378,380</u>
Operating margin	126,805	258,489	---	385,291
Impairment, abandonment and other charges		275,000	---	275,000
Depreciation and amortization	(16,425)	(87,966)	---	(104,391)
Interest expense	(12,214)	(51,241)	---	(63,455)
Interest and other income	13,209	14,904	---	28,113
Equity earnings of unconsolidated affiliates	36,241	22,718	---	58,959
Income tax (provision) benefit	(8,710)	70,920	---	62,210
Net income (loss) from operations	24,321	(112,006)	---	(87,685)
Cumulative effect of change in accounting principle	(7,289)	(7,511)	---	(14,800)
Net income (loss)	17,033	(119,518)	---	(102,485)
Identifiable assets:				
Domestic	\$ 1,882,965	\$ 2,299,312	\$ ---	\$ 4,182,277
Canadian	239,090	40,900	---	279,990
United Kingdom	54,635	---	---	54,635
Investment in unconsolidated affiliates	310,445	160,032	---	470,477
Capital expenditures	815,271	189,388	---	1,004,659

DYNEGY INC.

. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DYNEGY'S SEGMENT DATA FOR THE YEAR ENDED DECEMBER 31, 1996

	Wholesale Gas and Power	Liquids	Elimination	Total
	(\$ in thousands)			
Unaffiliated revenues:				
Domestic	\$ 4,422,849	\$ 2,800,813	\$	\$ 7,223,662
Canadian		36,540		36,540
United Kingdom	---			
	<u>4,422,849</u>	<u>2,837,353</u>	<u></u>	<u>7,260,202</u>
Intersegment revenues				
Domestic	80,943	242,291	(323,240)	
Canadian			---	
United Kingdom	---		---	
	<u>80,943</u>	<u>242,297</u>	<u>(323,240)</u>	
Total revenues	<u>4,503,792</u>	<u>3,079,650</u>	<u>(323,240)</u>	<u>7,260,202</u>
Operating margin	103,624	265,876		369,500
Depreciation and amortization	(3,897)	(67,779)		(71,676)
Interest expense	(2,179)	(44,023)		(46,202)
Interest and other income	4,825	660	---	5,485
Equity earnings of unconsolidated affiliates	20,696	7,379		28,075
Income tax provision	(19,792)	(36,531)	---	(56,323)
Net income from operations	50,907	62,416		113,323
Cumulative effect of change in accounting principle				
Net income	50,907	62,416		113,323
Identifiable assets:				
Domestic	\$ 1,467,990	\$ 2,635,318	\$	\$ 4,103,308
Canadian	34,917	30,507		65,424
United Kingdom	18,079			18,079
Investment in unconsolidated affiliates	52,500	129,188	---	181,688
Capital expenditures	6,324	821,848		828,172

DYNEGY INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 16 -- QUARTERLY FINANCIAL INFORMATION (UNAUDITED)

The following is a summary of the Company's unaudited quarterly financial information for the years ended December 31, 1998 and 1997.

	Quarter Ended			
	March 1998	June 1998	September 1998	December 1998
	(\$ in thousands, except per share data)			
Revenues	\$ 3,315,569	\$ 3,278,214	\$ 4,586,515	\$ 3,077,699
Operating margin	96,989	107,915	105,985	117,798
Income before income taxes	16,411	35,043	63,739	43,498
Net income	12,339	23,441	43,645	28,928
Net income per share (2)	0.07	0.14	0.27	0.18

	Quarter Ended			
	March 1997	June 1997	September 1997	December 1997
	(\$ in thousands, except per share data)			
Revenues	\$ 3,272,080	\$ 2,684,339	\$ 3,657,456	\$ 3,764,505
Operating margin	67,347	97,767	110,848	109,332
Income (loss) before income taxes	4,429	43,575	37,326	(235,225)
Net income (loss) (1)	4,614	32,128	25,028	(164,255)
Net income (loss) per share (2)	0.03	0.19	0.15	(1.09)

1. Fourth quarter results include the impairment, abandonment and other charges of \$275 million, on a pre-tax basis, and the \$14.8 million effect of the change in accounting principle.
2. Net income (loss) per share amounts have been restated to conform to the provisions of Statement of Financial Accounting Standards No. 128, "Earnings Per Share."

DYNEGY INC.
CONDENSED BALANCE SHEETS OF REGISTRANT
(in thousands, except share data)

	December 31, 1998	December 31, 1997
ASSETS		
Current Assets		
Cash	\$ 209,439	\$ 375
Accounts receivable	500	32
Intercompany accounts receivable	446,959	177,479
Prepayments and other assets	<u>6,773</u>	<u>4,992</u>
	<u>663,671</u>	<u>182,878</u>
Property, Plant and Equipment		
Less: accumulated depreciation	3,297	9,590
	<u>(2,587)</u>	<u>(3,755)</u>
	<u>710</u>	<u>5,835</u>
Other Assets		
Investments in affiliates	1,514,635	1,483,092
Intercompany note receivable	160,000	160,000
Deferred taxes and other assets	<u>205,536</u>	<u>77,366</u>
	<u>\$ 2,544,552</u>	<u>\$ 1,909,171</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities		
Intercompany accounts payable	\$ 155,131	\$ 8,289
Accrued liabilities	<u>146,100</u>	<u>16,764</u>
	301,231	25,053
Long-Term Debt		
	913,000	664,500
Company Obligated Preferred Securities of Subsidiary Trust		
	200,000	200,000
Other Liabilities		
	<u>2,258</u>	<u>493</u>
	<u>1,416,489</u>	<u>890,046</u>
Commitments and Contingencies		
Stockholders' Equity:		
Preferred stock, \$0.01 par value, 50,000,000 shares		
Authorized: 8,000,000 shares designated as Series A		
Participating Preferred Stock, 7,815,363 shares issued and		
Outstanding at December 31, 1998 and 1997		
	75,418	75,418
Common stock, \$0.01 par value, 400,000,000 shares		
Authorized: 153,298,220 shares issued at December 31, 1998,		
and 151,796,622 shares issued at December 31, 1997		
	1,533	1,518
Additional paid-in capital	935,183	919,720
Retained earnings	133,340	32,975
Less: treasury stock, at cost: 1,200,700 shares at December 31, 1998	<u>(17,411)</u>	<u>(10,506)</u>
654,900 shares at December 31, 1997	<u>1,128,063</u>	<u>1,019,125</u>
	<u>\$ 2,544,552</u>	<u>\$ 1,909,171</u>

See Note to Registrant's Financial Statements.

DYNEGY INC.
 STATEMENTS OF OPERATIONS OF THE REGISTRANT
 FOR EACH OF THE THREE YEARS IN THE PERIOD ENDED DECEMBER 31, 1998
 (in thousands)

	1998	1997	1996
Depreciation and amortization	\$ (241)	\$ (1,292)	\$ (496)
Impairment, abandonment and other charges	(959)	(3,886)	---
General and administrative expenses	<u>---</u>	<u>---</u>	<u>---</u>
Operating loss	(1,200)	(5,178)	(496)
Equity in earnings of affiliates	215,928	(115,108)	182,159
Intercompany interest and other income	13,667	16,928	17,968
Interest expense	(68,403)	(45,790)	(28,071)
Other expenses	<u>(1,301)</u>	<u>(747)</u>	<u>(1,915)</u>
Income (loss) before income taxes	158,691	(149,895)	169,645
Income tax provision (benefit)	<u>50,338</u>	<u>(62,210)</u>	<u>56,323</u>
Net income (loss) from continuing operations before cumulative effect of change in accounting	108,353	(87,685)	113,322
Cumulative effect of change in accounting principle (net of income tax benefit of \$7,913)	<u>---</u>	<u>(14,800)</u>	<u>---</u>
NET INCOME (LOSS)	<u>\$ 108,353</u>	<u>\$ (102,485)</u>	<u>\$ 113,322</u>

See Note to Registrant's Financial Statements.

Schedule I

DYNEGY INC.
STATEMENTS OF CASH FLOWS OF THE REGISTRANT
FOR EACH OF THE THREE YEARS IN THE PERIOD ENDED DECEMBER 31, 1998
(in thousands)

	1998	1997	1996
CASH FLOWS FROM OPERATING ACTIVITIES			
Net income (loss)	\$ 108,353	\$ (102,485)	\$ 113,322
Items not affecting cash flows from operating activities:			
Depreciation and amortization	1,864	9,631	1,996
Equity in earnings of affiliates, net of cash distributions	215,928	115,108	(182,159)
Deferred taxes	50,338	(86,424)	45,896
Other		12,344	7,466
Change in assets and liabilities resulting from operating activities:			
Accounts receivable	(468)	76	(108)
Intercompany transactions	(192,270)	636,063	(29X,592)
Prepayments and other assets	(2,212)	(2,749)	2,260
Accrued liabilities	3,693	1,529	8,487
Other, net	(29,778)	2,493	11,1931
Net cash used in operating activities	<u>155,448</u>	<u>585,586</u>	<u>(302,625)</u>
CASH FLOWS FROM INVESTING ACTIVITIES			
Capital expenditures	...	(5,121)	(2,055)
Acquisitions	(2,644)	(785,349)	
Other	
Net cash used in investing activities	<u>(2,644)</u>	<u>(790,470)</u>	<u>(2,055)</u>
CASH FLOWS FROM FINANCING ACTIVITIES			
Proceeds from long-term borrowings	212,259	2,218,500	1,542,000
Repayments of long-term borrowings	(493,277)	(2,198,000)	(1,231,000)
Net proceeds from commercial paper and money market lines of credit	350,758		
Intercompany advances			
Proceeds from sale of capital stock, options and warrants	3,863	203,190	858
Treasury stock acquisitions	(6,905)	(10,506)	
Capital contributions			---
Dividends and other distributions	(7,988)	(7,925)	(7,184)
Other financing	(2,450)		---
Net cash provided by financing activities	<u>56,260</u>	<u>205,259</u>	<u>304,674</u>
Net (decrease) increase in cash and cash equivalents	209,064	375	(6)
Cash and cash equivalents, beginning of period	<u>375</u>	<u>---</u>	<u>6</u>
Cash and cash equivalents, end of period	<u>\$ 209,439</u>	<u>\$ 375</u>	<u>\$ ---</u>
SUPPLEMENTAL CASH FLOW INFORMATION:			
Interest paid (net of amount capitalized)	<u>\$ 100,589</u>	<u>\$ 60,323</u>	<u>\$ 22,341</u>
Taxes paid (net of refunds)	<u>\$ (8,000)</u>	<u>\$ 8,043</u>	<u>\$ 1,444</u>
Cash dividends paid to parent by consolidated or unconsolidated subsidiaries	<u>\$ ---</u>	<u>\$ ---</u>	<u>\$ ---</u>

See Note to Registrant's Financial Statements.



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